

Enhancement to the Audit Assignment Process

Nicole Little

Department of Employment and Workforce

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### **Enhancement to the Audit Assignment Process**

The South Carolina Department of Employment and Workforce (DEW) is a state government agency that focuses on administering and collecting unemployment insurance taxes, paying unemployment insurance benefits to qualified candidates, and assisting the unemployed community with finding employment. Specifically this project focuses on the Field Service unit of the Unemployment Insurance (UI) Tax Department in DEW. One core function of the Field Service unit is to audit employer accounts to ensure that businesses are properly reporting and paying unemployment insurance taxes. From 2010 through September 30, 2013, the Field Service unit completed 6,442 employer audits generating over \$3.44 million of contributions (taxes) due from employers who did not report properly. Of the 6,442 audits 94% were randomly selected from the entire contributory employer population.

### **Purpose Statement**

Locke (2012) discusses that “the federal government estimates that employers who inappropriately classify employees as contractors cost as much as \$2.72 billion in lost tax revenue in 2006” (p.1). Employers who either misclassify workers or do not report employees on their quarterly contribution and wage reports negatively impact the integrity of the UI Trust Fund. The UI Trust Fund contains unemployment insurance taxes from employers. When an individual becomes unemployed, the individual has the opportunity to apply for unemployment insurance benefits. If the individual is qualified to receive unemployment insurance benefits the money is deducted from the UI Trust Fund.

DOL guidelines require that 1% of all active employers are audited annually. The average active employers from 2010 to 2013 were 96,846 which is an average of 968 required

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audits per year. From 2010 through September 30, 2013, 94% of all 6,442 audits assigned at DEW were random audits. 67% of audits resulted in no changes verifying that these employers audited were in compliance with DEW's reporting guidelines. Historical data indicates that DEW's audits primarily focus on random audits which result in 67% no changes (which verify that the employers are reporting correctly). The historical data indicates that DEW's primary method of audit selection focuses on employers who are in compliance with the reporting requirements rather than the employers who are either purposefully or unintentionally not reporting or paying taxes correctly. The problem is that by utilizing a method that dominantly focuses on the employers that do report correctly hinders DEW's efforts of ensuring that non-compliant employers are reporting and paying their fair share into the UI Trust Fund.

### **Data Collection**

#### *Consolidated Audit Reports*

The Consolidated Audit Report is an internal report that is generated by the Tracking Program. Data that will be gathered from this report is number of completed audits, change audits, block audits, reclassified employees, new employees, reclassified total wages, and 1099 audits. The terms are defined in Table 1.1 Program Terms. The data found on this report will provide a historical overview of audit findings.

#### *ETA 581 Contribution Operation Reports (ETA 581)*

The ETA 581 report is an internal generated report that is submitted to the Department of Labor (DOL) each quarter per DOL guidelines. Information that will be retrieved from the ETA 581 report are the number of completed audits, change audits, post audit wages, misclassified

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employees, and hours spent auditing (refer to Table 1.1 for definitions of these terms). The data found on this report will provide a historical overview of audit findings.

#### *Internal Revenue Service (IRS)*

The IRS 1099 cross-match is a data sharing resource between the IRS and DEW. DEW receives a list of this information and is able to use this information for audit planning purposes. This data will be used to determine how many potential cross-matches should be issued as an audit.

#### *Redeterminations (Block audit)*

A redetermination is a Field Service assignment generated when an individual who applies for unemployment insurance benefits does not have his or her wages reported in the tax system. This can happen if an employer did not report the wages in error, the employer does not have an account set up, or the individual may not have been an actual employee. The amount of redeterminations per employer is information that will be gathered as this information can be an indicator that the employer account should be audited to ensure compliance.

#### *Data from other states*

Each state has an employment department that is responsible for administering the state's unemployment insurance program. Information gathered from other states will include audit program details. These details will provide ideas of how other states are assigning audits to determine if DEW could possibly benefit from some of the best practices.

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Table 1.1 Program Terms

Tracking Program	<ul style="list-style-type: none"> <li>• Access data base program that tracks and records field service assignments and audit data.</li> </ul>
Completed audits	<ul style="list-style-type: none"> <li>• Audits that are completed and entered in the tax system (SCATS).</li> </ul>
Change audits	<ul style="list-style-type: none"> <li>• Audits that result in a change in any nature (new employees, reclassified employees, wages, status, etc.).</li> </ul>
Block audit/Redetermination	<ul style="list-style-type: none"> <li>• Audits that are issued as a result of a discrepancy on a claimant filing for unemployment however his or her wages have not been reported to DEW.</li> </ul>
Reclassified employees	<ul style="list-style-type: none"> <li>• Independent contractors reclassified to be employees.</li> </ul>
New employees	<ul style="list-style-type: none"> <li>• Individuals that were not reported as employees but should have been.</li> </ul>
Reclassified total wages	<ul style="list-style-type: none"> <li>• The amount of wages uncovered in an audit from reclassified employees.</li> </ul>
1099 audits	<ul style="list-style-type: none"> <li>• Cross-match information with the Internal Revenue Service that may indicate unreported wages.</li> </ul>
Focused audits	<ul style="list-style-type: none"> <li>• Employer audits that are preselected based on information that indicates there may be compliance issues. Some examples are block and 1099 audits.</li> </ul>
Post audit wages	<ul style="list-style-type: none"> <li>• Wages picked up during an audit.</li> </ul>
Hours spent auditing	<ul style="list-style-type: none"> <li>• Actual time spent preparing, conducting, and completing the audit.</li> </ul>

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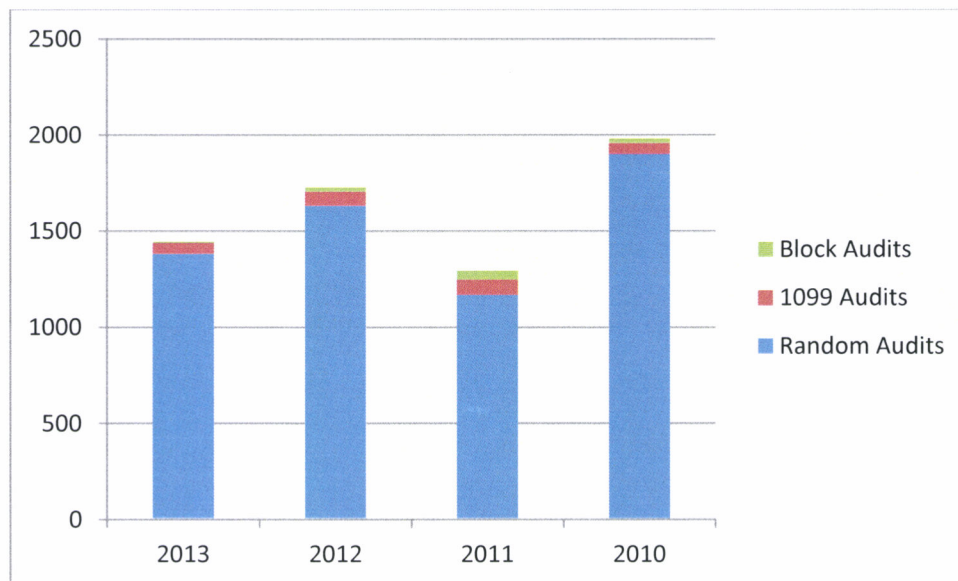
*Table 1.1 provides basic definitions for some program specific terminology used in this document.*

## Data Analysis

### *Consolidated Audit Reports and ETA 581*

Data retrieved from the Consolidated Audit reports indicate that the percentage of random audits assigned was 96% in 2010, 90% in 2011, 95% in 2012, and 96% in 2013. This illustrates that for the years of 2010 through 2013 less than 10% of all audits assigned were non-random audits. These figures are illustrated in Table 1.2.

*Table 1.2 Total Audit Assignments 2010-2013*

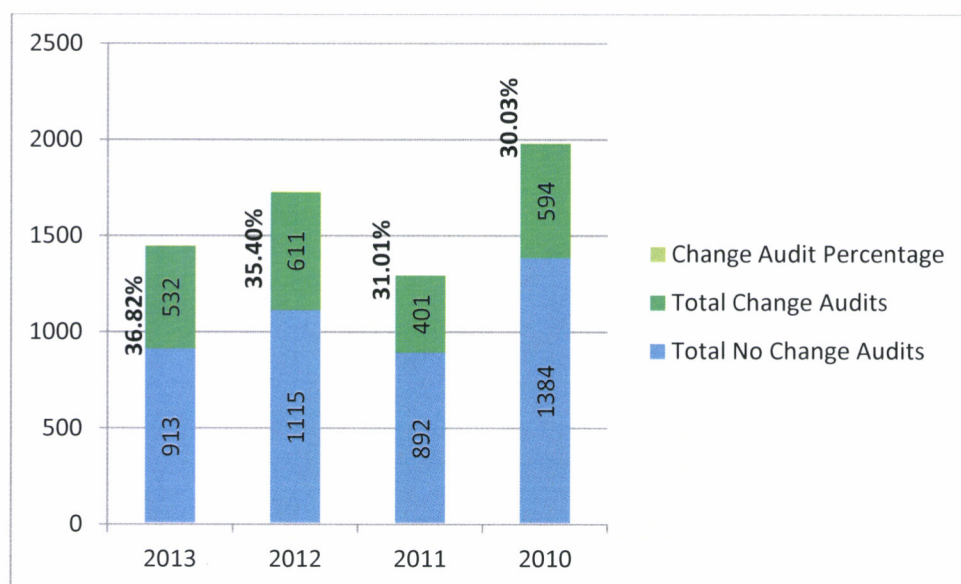


*Table 1.2 illustrates the amount of audits assigned by category (block, 1099, and random).*

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Data retrieved from the ETA 581 reports indicate that the change audit percentage (change audits divided by total audits) rates were 30% in 2010, in 31% in 2011, 35% in 2012, and 37% in 2013 (January 2013 through September 2013). The figures are shown in Table 1.3. Also for the years of 2010 through 2013 an average of 2,570 employees were picked up during audits as misclassified employees, the average wages picked up was \$40,274,605, and the average total of contributions owing as a result of audit findings was over \$3.44 million.

*Table 1.3 Total Change and No Change Audits 2010-2013*



*Table 1.3 illustrates the total audits, total change audits, total no change audits, and overall change audit percentages from the years of 2010 through 2013. 2013 totals are from January 2013 through September 30, 2013.*

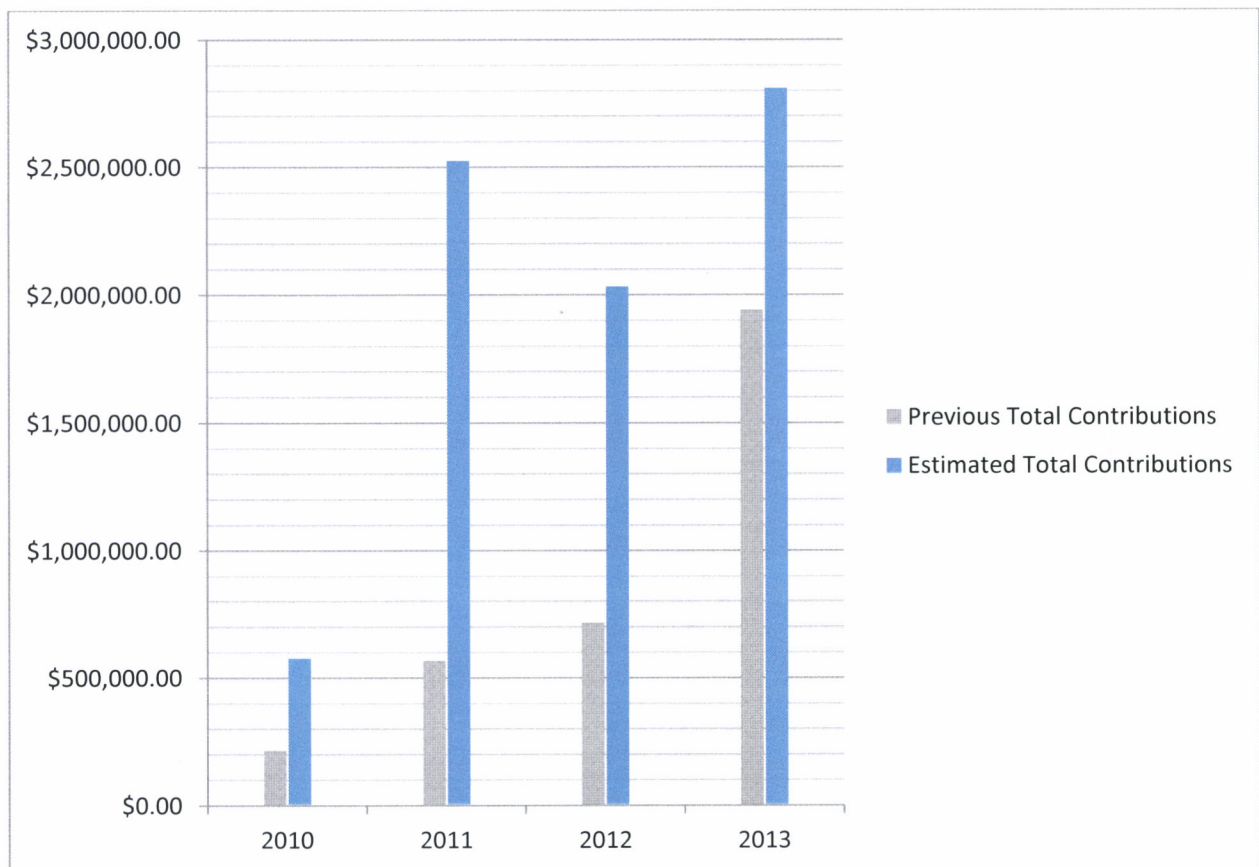
By analyzing data retrieved from the Consolidated Audit reports Table 1.4 illustrates the actual data retrieved from all audit findings during the 2010 to August 31, 2013 time period. Also Table 1.4 shows the estimated total contributions (taxes) that could have been generated through all audit findings had DEW assigned audits at a rate of 10% random, and 90% focused

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(employer audits that are preselected based on information provided from different sources that there may be compliance issues. See table 1.1 for examples.) which is estimated to be \$7.94 million (versus the actual \$3.44 million). This is an increase in \$4.50 million in estimated contributions that may have been uncovered through focused audits and owed to the UI Trust Fund. The formula used to estimate the total contributions that could have been assessed looked at the total focused and random audit contributions assessed per year, the total focused and random number of audits per year, the average rate of return per focused and random audit, and the percentage of focused and random audits assigned per year.

**Table 1.4 Actual Contributions Compared to Estimated Contribution (10% random, 90% focused)**



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*Table 1.4 illustrates the actual total contributions from all audit findings from 2010 through September 30, 2013 that were assigned 94% random and 6% focused. Also illustrated is the projected total contributions from all audit findings if the audits assigned were at 10% random and 90% focused. The estimated total contributions assessed from all years totaled \$7.94 million. This is a \$4.50 million increase in monies that could be owed to the UI Trust Fund.*

#### *Data from other states*

According to Locke (2012) the state of North Carolina realized that 30,000 businesses were failing to report their employees. Therefore, North Carolina assembled a task force to specifically investigate this issue. Davis, Jefferson, McPeak, Shinnick, and Lazenby (2012) discuss that Tennessee also formulated an Employee Misclassification Advisory Task Force to investigate employee misclassification due partly because “such conduct harms honest employers, mistreats workers, and costs the treasury uncollected revenue” (p. 4). Washington State created an Underground Economy Auditor program in which the auditors specialize in investigating non-compliant businesses. They also made enhancements to their audit program to increase the amount of focused audits. As a result the change audit percentage increased from in the 40% to the upper 60%.

### **Implementation Plan**

The data collected indicates that on an average between 2010 and 2013, more than 94% of all audits conducted were randomly generated audits, over 19,000 hours were spent conducting 6,442 audits, and more than 67% of these audits resulted in no changes. This implementation plan focuses on decreasing the amount of random audits to 10% or less. The remaining 90% of audits will be assigned from non-random categories such as 1099, block,

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delinquent reports, industry, and tips. 1099 information is received through a cross-match with the IRS. Block audit information is tracked internally by the Field receiving claimant inquiries on why their wages are not in the system. Delinquent report audits will be generated when an employer fails to report more than two consecutive quarters. Industry audits will be issued based on industry trends and research that indicate a pattern of potential compliance issues. Tips are information received from internal or external resources.

### *Action steps*

There are several action steps required for this implementation plan that are needed to complete this project which include:

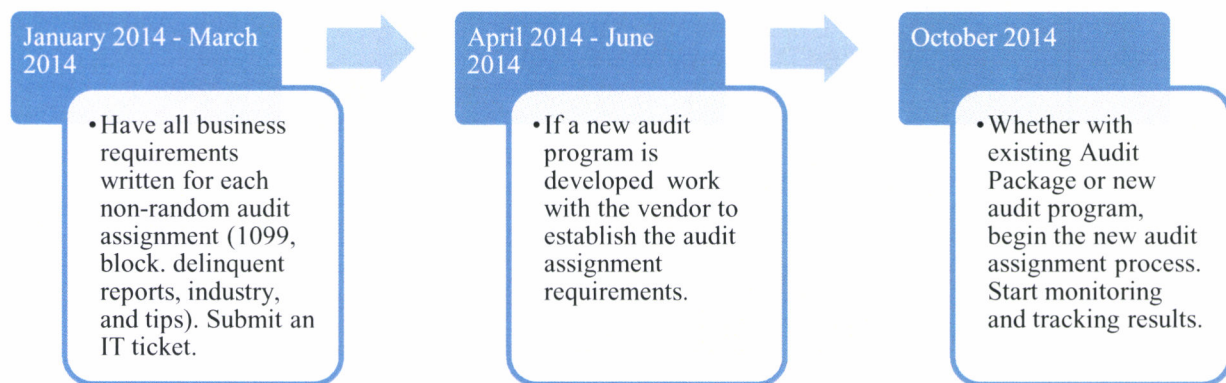
- Obtain approval from Unemployment Insurance Assistant Executive Director (UI AED).  
This action step was completed in 2013.
- Prepare and submit an Information Technology (IT) request to automate the assignment of audits. This includes writing the business requirements for selecting the 1099, block, delinquent reports, industry and tips audits.
- Provide communication and any additional training to Field Service teams on a continuous basis.
- Track and monitor results of audit findings.

### *Timeframes*

The projected timeline has several issues to consider. If the existing Audit Package is to remain, an IT ticket will be submitted to request the system enhancements. The IT ticket will be prioritized by executive management considering the entire Agency's needs. If the new audit program is selected the expected timeline will differ as there will be a minimum of a  
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three month creation and development phase of the entire audit program. The timeline is represented in Figure 1.1. Also there will be bi-weekly meetings with the subject matter experts to discuss the progress, issues, and communication of this project. At these meetings communication, training, and transitioning issues will be discussed. This is not represented in the timeline in Figure 1.1 as this will be an on-going event.

**Figure 1.1 Implementation Timeline**



*Figure 1.1 represents a high level timeline of the implementation phase for this project. The actual timeline will depend on the IT prioritization considered by executive management based on the needs of the Agency. The timeline can change based on the priority level.*

### *Costs*

There will not be any up-front costs required if the decision is to use the existing Audit Package. An IT ticket will be submitted and completed according to prioritization by executive management. However there will be secondary costs such as printing, mailing, and training.

There are expected up-front costs required if the decision is to purchase a new audit program. This expense has been projected into funds received specifically for Worker

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Misclassification Detection and Enforcement purposes. Also, there will be secondary costs such as printing, mailing, and training.

### *Potential Issues*

A potential issue is the current Audit Package (the audit computer program) is outdated and has been experiencing technical difficulties during 2013. A way to mitigate this risk is that we are currently pursuing the potential purchase of a new audit program. If the purchase of this new audit program is approved, rather than write business requirements for the existing Audit Package, the business requirements can be written into the new audit program.

A second potential issue is the adjustment and acceptance period for the workforce. Since over 67% of audits over the past couple of years have been no change audits, there is an expected dramatic increase in change audits. Change audits generally require more time, training, and subject matter expertise due to the issues that surround the audits. This change in workload may cause employee morale issues. A way to mitigate this risk is to communicate, educate, and train throughout and after the entire implementation process.

### *Potential Resources*

There are several potential resources that may be used during the implementation of this project. Internal resources include Field Service subject matter experts, the IT department, and the Training department. The Field Service subject matter experts will assist in the implementation of this project by assisting with writing the business requirements. The IT department is a resource that will ultimately make the enhancements to the Audit Package or coordinate efforts with the vendor for the new audit program. The Training department will be utilized to help develop training and communication materials for the users.

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External resources will include other state agencies, partner agencies, and industry associations. Other state agencies information can be used to help with the brainstorming process for best practices. Partner agencies may be contacted for cross-match information that may assist in assigning audits. Industry associations may be contacted to help spread awareness and education in the industry communities of common audit findings.

#### *Communication with key stakeholders*

A bi-weekly meeting will be established that will consist of the subject matter experts to discuss the progress, issues, communication, and action items. This team will develop communication and training materials for the Field Service unit. Also this team will plan and coordinate a training event for the users. Notes will be taken and sent out to all meeting participants. Information discussed during these meetings will be communicated to the Field Service unit during their weekly team meetings.

#### *Integration into standard operating procedure*

Integration into standard operation procedure will require minimal effort on the Field Service unit. The audit assignment will be an automated process in which the Field Service team member will receive the audit as normal procedure. However it is expected that by reducing the random audits there may be a large increase in change audits. This will impact the Field Service team members' workload and time constraints as it takes longer to complete a change audit than a no change audit. This consideration was evaluated and the following measures are taking place to reduce workload in other areas of the Field Service team members' functions:

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- Status unit will assist with Status assignments that can be completed by contacting the employer via telephone. Any Status assignment that requires a face to face visit will be referred to the Field Service unit. This will reduce assignments sent out to the field.
- Courtesy Summons will be centralized and mailed out by Administrative team members in the central office. This will reduce administrative and field work conducted by the Field Service unit.
- Any employer that has more than two delinquent reports will be issued an audit. This will reduce time and efforts of the Field Service unit from attempting to retrieve the report on numerous occasions as the report can be retrieved at the scheduled audit.

### **Evaluation Method**

Audit results will be monitored and tracked each month using either the enhanced Audit Package or new audit program's reporting capabilities. The monthly review will also consist of what went well and what needs improvement. The Unemployment Insurance Tax Director will make adjustments to the audit assignments as needed. The Unemployment Insurance Tax Director will provide a quarterly update and historical comparison to the UI AED which may be used to compare the yield on audits from the previous years.

### **Conclusion**

The purpose of this project was to identify a problem, conduct research and data analysis, propose a solution, and provide an implementation plan. Over the past 3 years DEW's audit program has generated over 6,442 audits, reclassified 10,273 employees, and uncovered over \$3.44 million owed by employers to the UI Trust Fund. These accomplishments were achieved by using a primarily random audit assignment process (94% random audits, 6% focused). The

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recommendation to enhance to the current audit assignment process by using a 10% random rate, and a 90% focused audit rate will not only be focusing more efforts on ensuring that non-compliant employers are reporting and paying their fair share, but will also improve the integrity of the UI Trust Fund by uncovering monies that should be assessed. This recommendation allows for DEW to help ensure that all employers are held to the same reporting requirements and are paying their fair share so that the employers who are compliant are not being penalized for those employers who are non-compliant.

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## References

- Davis, K., Jefferson, K., McPeak, J. M., Shinnick, M., & Lazenby, C. (2012). Employee Misclassification Advisory Task Force (EMATF) 2012 Annual Report. Retrieved August 2, 2013 from: <http://ui.worforce3one.org/news>.
- Locke, M. (2012) *Task force to deal with employers who wrongly classify workers*. Retrieved August 2, 2013 from: <http://ui.worforce3one.org/news>.